

# Global Political and Economic Restructuring through Free Trade Agreements (FTAs)

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## Abstract

Research on deeper economic cooperation by preferential trade agreements (PTAs) has mostly centered on the economic implications of the PTAs for decades. A number of alternative analyses emphasize the role international power relations and multilateral institutions play in the formation of regional economic initiatives either positively or negatively. The new generation of FTAs differs from earlier waves of similar agreements of the nineteen and twenty centuries. They are probably much less about economic benefits than geostrategic objectives and global political concerns. It is, however, almost inevitable that in a period of uncertain economic growth “...the ultimate success of the negotiations and the long-term viability of the arrangements turn more on economic and commercial considerations” (World Economic Forum 2014: 18).

## Introduction

For decades, mainstream research focused almost exclusively on the economic implications of preferential trade agreements. In most cases *ex ante* theoretical studies and impact assessments have emphasized mostly the positive impacts experienced by the countries participating in such arrangements, while possible negative outcomes were considered unlikely scenarios.<sup>1</sup> Recent international trade discourse has been dominated by mega-regional trade agreements.<sup>2</sup> These trade agreements can produce widespread and often unforeseen effects on domestic economies, international relations and politics. These impacts are very diffi-

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<sup>1</sup> According to the literature, there seems to be a consensus that earlier arrangements in the nineteenth century were more positive in terms of trade creation while those between the world wars were mostly trade diverting. But regarding the implications of preferential trade agreements concluded after World War II there is no consent at all (Mansfield 1999: 593).

<sup>2</sup> In this paper the term “mega-regional” FTA is used to mean agreements that involve three or more countries; cover at least 25 percent of global trade flows; and include regulatory commitments rather than trade liberalization (Draper, Lacey, Ramkolowan 2014: 8). From another perspective, these deals can be classified as deep arrangements which cover several measures beyond tariffs. These agreements also change tariffs but the most important implications relate to nontariff barriers, regulations and standards, or other similar measures (Lawrence 1996).

cult to forecast or fully understand given the uncertainties regarding the content of the final agreements and lack of consent about the impacts of such large-scale arrangements. Mutually advantageous implications of ambitious free trade agreements under negotiation, however, cannot be taken for granted.

In the past decade the multilateral system administered by the WTO came under challenge. A number of rapidly developing countries do not share the core principles that have underpinned open rules-based commerce or more precisely, they do not accept the rules of Western dominated institutions without having their say properly heard. Several states consider that traditional institutions of international economic relations and regulation do not take into account the changing global power relations. Large emerging countries including China, India or Brazil are becoming increasingly important economic and political players globally (or regionally – Russia); but, their weight is not fully reflected in the international power relations.<sup>3</sup> Most advanced countries consider this development to be a major challenge to the international economic and political system – the very system they once used to have almost exclusive influence over the world. These different interests led to either the paralyzation of some international organizations or to their reforms (the IMF is a good example) or to the deadlock of their operations (e.g. the WTO) or to increasing political and security challenges (Russia).

Given these significant changes, it seems that the declining global hegemony of the US – mostly in terms of economic indicators – and the very poor economic performance of the European Union, have contributed to the current wave of regionalism through deep trade deals. It is also most certainly true that we have entered into a new phase of international power relations.<sup>4</sup> The new mega-deal proposals constitute a new-generation of negotiations aimed at repositioning economies in a more intensified global competition. Other opinions go further by emphasizing that the new generation of FTAs may be an appropriate means in managing the challenges of emerging countries. On the other hand, however, these agreements are feared to undermine the social model of Europe. The basic question for many analysts and policy makers in Europe is how the economic problems can be managed in a sustainable way while preserving the values of the social market economic systems that Europe is justifiably so proud

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<sup>3</sup> For example, the organizational reform of IMF has been stalled since 2010 by the obstructions imposed by the US Senate. The reform would grant increasing voting powers to developing countries. See, for example, the latest coverage: Statement by IMF Managing Director Christine Lagarde on IMF Quota and Governance Reforms. For more information see Press Release No.14/568, December 12, 2014 accessible at <http://www.imf.org/external/np/sec/pr/2014/pr14568.htm>

<sup>4</sup> As Pascal Lamy, Director-General of WTO in 2012 put it: “The old theories and hypotheses which governed the way we looked at trade in the twentieth century will require better calibration with the new reality of trade in the twenty-first century.” Article available at: [http://www.wto.org/english/news\\_e/sppl\\_e/sppl258\\_e.htm](http://www.wto.org/english/news_e/sppl_e/sppl258_e.htm)

of (e.g. labor regulations, environmental protection, health care and pension systems etc.).

Today mega-trade deals seem to be used more extensively to influence future economic, political and interstate power relations on a global scale. The uncertainties, however, regarding the impacts of these agreements are significant and no one can predict the future with much confidence. The economic arguments in support of TTIP (Transatlantic Trade and Investment Partnership) and TPP (Trans-Pacific Partnership) seem to be based on wishful thinking – an approach that several times has biased the fair *ex ante* evaluations of PTAs or deeper economic cooperation (Barbee 2014: 208).

### **Waves of Free Trade Agreements**

The underlying reasons behind the establishment of Free Trade Agreements have been numerous since the second half of the nineteenth century when the very first wave of such arrangements was initiated. In addition to the bilateral free trade agreement between Great Britain and France in 1860, which involved the MFN clause, several customs unions were also established at the time (Austria-Hungary, Germany, Italy etc.) which had led to a remarkable trade liberalization, an almost complete single market in Europe by the turn of the century, covering a very large share of the global trade flows. Between the two World Wars a completely different international economic system emerged in which the new regional arrangements had caused trade to divert and eventually separated trade blocks from each other and, as such, pursued inward looking, trade protectionist policies. All such initiatives were highly preferential in the time of the Great Depression.

Although expected, economic benefits have always been one of the most important driving forces behind the waves of regional economic integration, from time to time, additional interests and objectives would surface. There have been times when economic benefits were subdued to international political interests. We witnessed an especially complex set of motives after World War II. Some of the most important perspectives are as follows: (1) FTAs were often utilized by larger states to intensify their economic and political influence on smaller countries. A prime example for this type of motivation is the establishment of COM-ECOM (Council for Mutual Economic Assistance) in order to coordinate the economic development in Eastern Europe, but it goes without saying that control over this geographically vast economic integration was in the hands of the Soviet Union. (2) An additional motivating force behind the birth of FTAs was the desire to reduce the collective dependence of groups of states on third parties. Typical examples include the regional initiatives between developing countries during the fifties and the sixties in order to mitigate their vulnerability in international economic relations against more developed regions. (3) The establishment of the European Communities after World War II seems to be the most successful at-

tempt at managing the security policy challenges posed by the Soviet Union. (4) In other cases regional arrangements promoted and consolidated domestic economic reforms and democratic transformation. This was the case of the EU integration of Greece, Portugal, and Spain. The waves of enlargement in the European Union have demonstrated that economic integration can usefully serve as the driving force for political cooperation and as a means of “stability export” both in economic and political understanding.

While stronger economic ties or broader economic opportunities worked well in developed Western European countries, economic integration and cooperation between less developed countries were less successful. By the end of the eighties, several earlier assumptions had changed. Reforms and political transformation had taken place in many parts of the world which created a new framework for trade agreements. In less developed countries the earlier autarchy-oriented, inward-looking policies had changed. Import substitution strategies and integrations have always faced the same burden: lack of capital, the inability to obtain the latest technologies, and the scarcity of qualified labor force. These countries started to become more open towards international economic (trade and FDI) cooperation. The collapse of the Soviet Union and the economic and political changes in the Soviet space prompted a number of countries to stabilize their internal transformation by entering the European Union. In addition, in the Post-Soviet region we also witnessed several attempts by Russia to create a sort of economic integration. In this period, the objective of small countries became increasingly centered on the need to align and integrate with a large “center” – it was expected that several benefits may be associated with this adjustment, including the inflow of FDI, improving export performance and the stabilization of political systems after transitioning from an autocratic regime to a democratic one.

### **Changing Interstate Power Relations and the Role of FTAs**

After World War II, the GATT liberalization and the establishment of preferential trade arrangements went hand in hand for several decades and they seemed to be complementing each other. But, because of the significant changes in the global business environment and interstate power relations recently, the two processes started to move in completely different directions. These changes had contributed to the emergence of a new wave of regional integration efforts completed now with several novel features.

(1) In contrast to previous decades, trade liberalization in the manufacturing of goods in the multilateral framework had deepened. As a result, the potential benefits of free trade agreements stemming from the elimination of tariffs would only make a limited impact in most cases. In other words, the Vinerian balance of losses and benefits in terms of trade diversion and trade creation – even in theory – should be small without additional efforts to extend the scope of

the arrangements. (2) Foreign direct investments of recent years resulted in the emergence of global value chains that strengthened multiple economic ties not only between neighboring countries, but across regions and continents. FDI links and relations became much more convoluted compared to previous decades (centuries) due to the new strategies of large transnational firms. (3) Some of the arrangements made since the nineties started to become deeper and deeper as they were no longer just about tariff cuts. Non-tariff barriers were also being eliminated or other fields of economic policies were being harmonized. (4) The discrepancy between global liberalization and regional cooperation became even more evident. Multilateral trade negotiations stalled and very little or no advancement was made in this regard. (5) Once hailed as the most successful integration effort, the European Union and most importantly the Eurozone were facing a series of crises ranging from economic growth problems to income inequalities and social hardships. (6) The shift in the global economic balance of power intensified after the turn of the millennium and was coupled with the consequences of the economic crisis unfolding after 2008. It was against this backdrop that negotiations of mega-regional trade agreements were started with the objective of establishing deep integration with countries that possess overwhelming shares in global trade and FDI and place central role in the emerging global value chains – a development that has attracted great attention in recent years from among scholars and large international economic institutions.<sup>5</sup>

Due to these changes, the twenty and twenty first century regional trade agreements or regional arrangements should be fundamentally different from each other. As Richard Baldwin puts it: “[t]wentieth-century RTAs concern ‘made-here-sold-there’ goods, while 21<sup>st</sup> century regionalism concern ‘made-everywhere-sold-there’ goods. The difference means that 21<sup>st</sup> century RTAs include rules on *making* goods as well as *selling* them” (Baldwin 2014: 5). The mega-regional deals are increasingly thought to be motivated not simply by economic objectives, but more importantly by geopolitical considerations (or simply by international political objectives) which is not in contradiction with the previously mentioned diverse set of motivations behind earlier trade arrangements.

Referring to more details, the following motives can be identified behind the large objective of “geopolitics.” (1) In recent years, economic growth in the world has been uneven. Large emerging countries have experienced rapid economic convergence led by China’s catching up in the past decade, but other states also have shown growing influence on global economic developments and trade. China has overtaken the US in term of its share in global GDP (it is measured at PPP, but it is still an important development).<sup>6</sup> As a result, the soft power of

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<sup>5</sup> See inter alia for example: Interconnected Economies. Benefiting from Global Value Chains. OECD Publishing. <http://dx.doi.org/10.1787/9789264189560-en>; or IMF 2013. etc.

<sup>6</sup> For most recent data see the World Economic Outlook of the IMF see <http://www.imf.org/external/pubs/ft/weo/2014/02>.

emerging countries and especially that of China may challenge the soft power of the US and the EU (Stiglitz 2015). (2) The European economy has been struggling since 2008. Lack of economic growth and emerging social problems in a number of member states are threatening the very foundations of the EU. It seems that we are not only dealing with temporary economic stagnation affecting a few countries, but with a rudimentary, systemic problem, the crisis of the Eurozone. As a result, dissatisfaction among the population is increasing, domestic political challenges are growing and future prospects are unclear.

The emergence of contemporary large deals is explained by the need to set standards to which emerging nations should adjust if they wanted to benefit from international economic relations with large industrialized nations. These new trade arrangements may win some time for the current most developed countries: if these deals succeed, and emerging countries adjust, then they will follow western rules and comply with liberal market economic principles. Economic benefits of FTAs – and deeper cooperation – are not at all obvious today. *Ex ante* and *ex post* analyses of FTAs also differ from each other considerably and in recent decades it has been almost impossible to separate the economic impacts of institutionalization of cooperation (e.g. a free trade agreement) and the impacts of overall global liberalization (Vetter 2013: 3). While geopolitical motives may be important from the perspectives of the launching and negotiating mega-regional trade agreements, these considerations are insufficient to implement them in a long term sustainable way. In other words, “TTIP at its core is an economic negotiation that in the end will stand or fall on its economic merits” (Hamilton 2014: VII).<sup>7</sup>

Many decision makers and analysts view the emergence of these agreements as a tool to influence interstate power relations – an approach that seems to be similar to the race during the Cold War between the West and the East. According to this perspective, the changing economic realities may be influenced by building blocks that are unified by the unlimited liberalization of economic flows and regulation. This way the free trade agreements may serve as a means to strengthen political alliances with long term partners in the developed world. Building blocks also seem to follow the logic of the interwar period. An important difference from the interwar period is the existence of the WTO, a multilateral institution that may mitigate the risks associated with building blocks – provided it can function properly. If not, the future of international economic relations and the prospects depend on the reaction of large emerging countries currently not participating in the negotiations.

Here an interesting theoretical notion put forward by Paul Krugman is worth considering. According to Krugman, if a country with PTA tries to use its power to influence global trends; this may lead to disastrous consequences if oth-

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<sup>7</sup> A recent paper argues that official studies do not offer a solid basis for an informed decision on TTIP. See Capaldo 2014.



er similar agreements are in place because “the blocs may beggar each other. That is, the formation of blocs can, in effect, set off a beggar-all trade war that leaves everyone worse off” (Krugman 1991: 8). According to him, these negative impacts may only be minimized if trade blocks are few or if there is a very large number of such arrangements. If there is only one block, then it is global free trade. He argues that “world welfare is minimized for a world of three trading blocs” (Krugman 1991: 12). If we consider this, it is remarkable that the share of TTIP and TPP in terms of global GDP and global trade is over fifty percent (excluding the double counting of the US). From this perspective, the idea of RCEP (Regional Comprehensive Economic Partnership) may attract greater attention in the future.

### Options and Conclusions

If the US led mega-deals fail, it will hurt the image and leadership of advanced countries in international trade issues in favor of emerging nations, most importantly China. If the deals are successful, developed countries will get additional leadership by setting norms and regulations for large segments of international trade flows (Dube 2014: 17). Taking into account the above considerations, the most important question concerns the response of third countries, especially large emerging countries having a major role in formulating global shifts and changes. The basic strategies are the following.

1. *Wait and see.* There are a lot of uncertainties surrounding these deals especially the TTIP because of the widely different opinions within the European Union. Most critics are focusing on the ISDS (Investor State Dispute Settlement), environmental protections or GMO (Genetic Modified Organisms) products. For third countries, it is reasonable to wait and see what the final outcome of the agreements concerned will be. The external situation and the negotiation positions may change significantly. It cannot be ruled out that significant concessions and compromises will be the only solution for consolidating these diverging interests. Just to mention one issue: probably it would be reasonable to abandon the ISDS in its current form in TTIP negotiations given the very negative opinions and sentiments of a wide circle of stakeholders.<sup>8</sup>

2. *Disengagement from global trade liberalization.* If multilateral trade negotiations are blocked because of internal conflicts (between advanced and emerging states) then several countries may become even more disinterested in international trade liberalization. Mega-trade deals coupled with slow progress in multilateral trade negotiations could easily result in developing inward-looking or more protectionist policies in several countries.

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<sup>8</sup> Among many other proposals see for example: Congressional Financial Services Committee leaders: Exclude ISDS from US-EU deal <http://www.bilaterals.org/?congressional-financial-services&lang=en#sthash.Q9Kwk01h.dpuf>.

3. *Unilateral significant liberalization of excluded countries.* This would serve as a means to mitigate the trade diversion impacts due to mega-deals. Although it is not very likely, theoretically we can construct a framework where outside countries with large liberalization or adjustment efforts can simply eliminate most of the advantages of the participants in mega-trade deals while preserving some independence in their regulatory framework (World Economic Forum 2014: 28-29).

4. *Joining mega-deals.* This is the same strategy that was followed by mostly smaller countries in earlier decades when they considered it their interest to swiftly adjust to the rules defined by larger countries. This is a quite reasonable strategy for small states with insufficient domestic factors of production to boost growth. The situation may be different for large countries, but even in their case, bilateral negotiations of a certain kind with the EU or the US may be feasible. In fact, this would be the best scenario for advanced nations since this would mean that large emerging countries are willing to adjust to the rules set by the US and the EU. As a result the rule setter and rule taker position would not change much globally.

5. *Trade war by establishing new trading blocks.* Although trade between large outside countries is somehow limited mostly for geographical reasons, theoretically, the establishment of other trade deals with the participation of large countries and nations from the African continent, Far Eastern and South American countries cannot be ruled out. China, India, Indonesia, Russia, Brazil and Nigeria altogether make up almost 45 percent of the global population. If we accept that mega FTAs currently negotiated are more and more driven by political and strategic interests and not only by economic ones, the establishment of alternative competing arrangements may be a realistic option.

6. *Revitalization of the WTO.* As stated in the World Economic Forum (2014), “[i]f the RTAs and their power asymmetries take over, there is a risk that the GATT/WTO would go down in future history books as a 70-year experiment where world trade was rules based instead of power-based” (27). Something similar happened to the IMF before the economic crisis of 2008. Current perspectives for larger engagement of WTO in global trade talks are low. Hopes, however, are realistic given the small steps taken in the Bali ministerial meeting, which were celebrated loudly. In fact, for the time being, these small agreements saved the WTO from falling into oblivion. Its future existence is still not based on strong foundations. The role of IMF in global affairs was revalued due to the economic crisis. If mega-deals fall short of expectations, the WTO can still serve as an instrument of global cooperation in international trade.

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